IGEA

interactive games & entertainment association

Submission to the Treasury

Response to the Digital Games Tax Offset Exposure Draft Legislation & Explanatory Statement

April 2022

We acknowledge the Traditional Custodians of Country throughout Australia and their continuing connection to the land and sea. We pay our respects to all Aboriginal and Torres Strait Islander peoples, their cultures and to their elders past, present and emerging.

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Background

About IGEA

The Interactive Games & Entertainment Association (IGEA) is the industry association representing and advocating for the video games industry in Australia, including the developers, publishers and distributors of video games, as well as the makers of the most popular gaming platforms, consoles and devices. IGEA also organises the annual Games Connect Asia Pacific (GCAP) conference for Australian game developers and the Australian Game Developer Awards (AGDAs) that celebrate the best Australian-made games each year. IGEA has over a hundred members, from emerging independent studios to some of the largest technology companies in the world. A full list of our membership is available on our website.

Industry's reaction to the DGTO

As we declared in our responses to both the initial announcement of the Digital Games Tax Offset (DGTO) last year and the release of the Exposure Draft Legislation (the Legislation) and Explanatory Statement (the ES) this March, we wholeheartedly applaud and embrace this policy. For years, IGEA has pushed and advocated for the establishment of a tax incentive for game development, winning over countless government agencies, elected policymakers and parliamentary committees along the way. When the DGTO was finally announced just prior to the 2021-22 Budget, together with the video games industry and the game-loving Australian public we reacted with elation and positivity, not only towards the Government's recognition that our sector is one that deserves to be backed, but in anticipation of the long-term investment, job creation, creative output and economic activity that will be triggered by the DGTO. The DGTO will not only allow Australian studios to ramp up their ambition to attack the global market with their high-value digital exports, but it will also make Australia an attractive destination for investment and expansion from a global games industry that pours tens of billions of dollars each year into making games and gaming-related products and services.

Summary of consultations to date

While this is the Australian Government's first formal public consultation process for the DGTO, we recognise that relevant agencies have undertaken detailed research and consulted extensively with industry in preparation for drafting the present Draft Legislation and Draft ES. We and dozens of our members have had the opportunity to be a part of these consultations and we thank the Government for listening. We also acknowledge that relevant agencies have also undertaken environmental scans of the global policy landscape to uncover best practices.

We would particularly like to thank the Office for the Arts within the Department of Infrastructure, Transport, Regional Development and Communications for displaying a genuine commitment and curiosity towards understanding how the DGTO could be most effectively designed, as well as to thank the Treasury for supporting this policy. We also thank both Departments for their positive engagement through the present consultation, including their generous participation in a workshop with our members in March. We further thank the many agencies that have advocated for the DGTO and other policies, sometimes over many years, to support a thriving games sector, including the Global Business and Talent Attraction Taskforce, Austrade and the Small Business and Family Enterprise Ombudsman. Finally, we extend our gratitude to the many federal MPs and Senators on all sides who have shown an interest in our medium and industry, including the members of the Parliamentary Friends of Video Games Group, and especially to those who have fiercely lent a voice to our sector.

Outline of our response

Context to our recommendations

While we have outlined several recommendations for improving the Draft Legislation and Draft ES, we would like to recognise that much of the Government's proposed design for the DGTO has clearly been informed by thorough analysis and consultations with industry.

Both the Draft Legislation and the Draft ES generally reflect a high degree of clarity and it is also obvious that great care has been taken by the bill drafters to understand and accommodate the game development process. The Draft Legislation includes a range of features that demonstrate a thoughtful desire of the Government to create effective policy. For example, we appreciate that the Government has already taken the step of expanding the DGTO through the 2021-22 Mid-Year Economic and Fiscal Outlook (MYEFO) to include expenditure on live services, a direct outcome of listening to industry's early feedback. Other strategic elements of the Draft Legislation include an absence of a time limit for businesses to reach the minimum qualifying development expenditure for a completion certificate, the provision of a specific porting certificate and an allowance for annual claims for ongoing development certificates.

We also appreciate that while we provided a range of suggestions to the Government last year to inform the development of the Draft Legislation, new reform necessarily involves difficult policy choices needing to be made, including some that the industry will consider to be sub-optimal. Nevertheless, while preliminary design decisions have been made, the Government has sought feedback on the Draft Legislation in recognition of the fact that major and potentially unrecognised or unintended problems in the proposed design should be identified early so that they can be rectified. Recognising that the present consultation process is likely the only opportunity that industry will have to formally respond to the details of the DGTO, we have carefully outlined these major issues where they are apparent to us, highlighting especially where we believe they present a key risk to the core functionality of the DGTO, as well as other recommendations to strengthen or improve the clarity of the Draft Legislation.

Our response also includes some additional recommendations that we believe will help the DGTO to most effectively reap its objectives of supercharging economic growth, creative output, job creation and inbound investment. While we recognise that some of these recommendations may have already been considered during the initial announcement or design of the proposed DGTO model, we have tried to demonstrate their strategic value in our submission and we ask the Government to approach and re-assess them with an open mind.

While references to 'the Government' in this submission generally refer to the Australian Government as of the release of the Draft Legislation and Draft ES, we are of course aware that during this consultation window the 2022 federal election has been called, meaning that the Government has entered the caretaker period and no further policy will be progressed until the election is resolved. As a result, these recommendations are also drafted with both a potential returned or new government in mind.

Finally, notwithstanding the importance of the Legislation needing to be 'done right', we also ask the Government to resolve and introduce it into Parliament as expediently as possible, noting that many studios at home and major games companies abroad have already tentatively made business and investment decisions in anticipation of its finalisation.

Summary of our recommendations

We have articulated our recommendations across two main sections outlined in the following pages. In setting out these recommendations, we have been conscious to avoid unnecessarily relitigating questions of policy design that we know the Government has already analysed and made decisions upon except where we believe it is necessary to do so or where we believe there is evidence that has not yet been fully considered.

In the first section, we outline our eight most important recommendations that we ask the Government to adopt as matters of high and urgent priority:

1. Remove the rule excluding expenditure not 'wholly independent' or 'arm's length'
2. Remove the requirement for a game to be released
3. Enable businesses to apply for and receive provisional certificates
4. Reduce the minimum QADE requirement for porting certificates
5. Clarify that businesses that work on a part of a larger project are eligible
6. Remove the phrase "transferred or" from the description of loot boxes
7. Clarify or revise the rule regarding 'related companies' and the $20 million cap
8. Revisit the $20 million annual limit for businesses claiming the DGTO

In the second section, we have also provided a further eight recommendations that we strongly ask the Government to adopt:

9. Add additional categories of game developers to the specific inclusions
10. Include expenditure on game-related technology and architecture development
11. Clarify the rule against expenditure on 'further sub-contracting'
12. Soften the penalty where related companies' claims exceed $20 million
13. Clarify in the ES that 'ongoing development' also means maintaining a game
14. Timing of game release to mean the official launch
15. Consistent language regarding the 'general public'
16. Confirm that employee remuneration can be split across multiple claims

Further to these recommendations, we also flag two additional matters that have been raised by members, being: the $500,000 minimum QADE requirement for completion certificates. While we have not necessarily framed these matter as specific recommendations, we believe that it is still important to raise them with the Government for further consideration now or in the future.

Key recommendations

1. Remove the rule excluding expenditure not 'wholly independent' or 'arm's length'

378-30 Development expenditure

(3) Despite subsections (1) and (2), the following expenditure of a company in relation to a *digital game is not ***development expenditure***:

(o) expenditure incurred in relation to an entity that is not wholly independent from the company;

(p) expenditure incurred in connection with a transaction in which the company and another party to the transaction did not deal with each other at *arm's length;

Draft ES

1.78 'Arm's length' is defined in section 995-1 of the ITAA 1997 to mean that when determining whether parties deal at arm's length, consider any connection between them and any other relevant circumstance. However, 'wholly independent' is not defined and takes on its ordinary meaning. Whether or not the expenditure will be excluded under these provisions will be a matter of fact and degree.

1.81 Similarly, expenditure incurred in relation to an entity that is not wholly independent from the company is totally excluded. An entity may not be wholly independent on the basis of a range of factors, including the degree of influence it may be under, due to common ownership, or due to the personal relationships of key individuals. Given the scope that related parties have to determine non-commercial prices and relationships that would affect the amount of eligible expenditure, this treatment provides a powerful disincentive to engage in transactions with related parties. Nevertheless, a company is not prevented from engaging in a transaction with a related party; it is only unable to claim such expenditure as eligible expenditure under the DGTO.

The exclusion of expenditure incurred "in relation to an entity that is not wholly independent from the company" or "in connection with a transaction in which the company and another party did not deal with each other at arm's length" at 378-30(3) is highly problematic and must be removed or fully redesigned.

In addition, the ES should specify that expenditure on workers with minor equity in a business, such as the salary of employees who hold equity in a business through employee share schemes and similar arrangements, will generally be considered QADE.

Impact on the 'indie' game development sector

While we understand the principle behind this integrity measure, it is drafted indiscriminately and without specificity. For example, 'wholly independent' is not defined in the Draft Legislation while the definition of 'arm's length' is unhelpfully vague. We are particularly concerned because, based on our understanding of how the exclusion is drafted, it would potentially have such a catastrophic impact on the effectiveness of the DGTO that it will essentially exclude a significant proportion - if not a majority - of Australian home-grown game development studios from ever being able to claim the DGTO.

One of the most practical, sensible and common ways for promising independent ('indie') studios to be structured is for the studio to be owned by some or all of the people who also work on making its games. This is consistent with the general practice of tech 'start-ups', which many games studios tend to be. For example, three talented game developers may band together to create a new studio by obtaining an ABN, pooling resources and attracting investment for a new game. The three leads would be co-owners and potentially also directors of their new studio, incentivising the investment of their own capital as well as allowing them

to fully leverage their collective vision. However, they would also work on developing the new game themselves, such as by taking core roles such as game designer, art director and lead programmer. To survive, the three leads would pay themselves salaries, which would typically be very modest, lower than the market value of the skills they possess and often lower than the salaries of other equivalent developers they hire to support the project.

Under the current proposed design of the DGTO, not only would such a studio potentially be excluded from claiming the salaries of the three director/employees, but it would also probably not be able to claim any other expenses for the new game, such as additional staff. This is because without the primary developers' salaries being considered QADE, the game's budget would be unlikely to reach the required minimum threshold of $500,000 (many indie game budgets, including for highly promising projects, are little greater than $500,000).

Many if not most of the most venerated Australian 'indie' games of the past decade have been made in this way and would therefore have been locked out of accessing the DGTO. For example, one of our members has told us that their first project was developed by a team of six including the studio owner, who was a key member of the design team. If the DGTO had been available but the owner's salary not been considered eligible QADE, the project would not have reached the $500,000 minimum spend required. Since developing this first game, the project has returned well over ten times the value of the title's original budget and was instrumental in allowing the studio to grow from 6 to 21 developers working on three games simultaneously. While this particular project was able to be achieved without the DGTO, many other projects that can achieve similar success would not be able to get off the ground without the DGTO's support.

Fixing this problem while preserving integrity

We are not aware of any other game development offset, rebate or credit anywhere in the world that has been designed with such an exclusion.

It is also our understanding that neither the Government's Producer, Location nor the PDV Offset has such an exclusion. Given that the DGTO is primarily a labour rebate and there are already so many non-labour exclusions (compared to the Government's film and TV tax offsets), its scope should not be unduly restrictive regarding labour. We therefore strongly recommend that this exclusion in the DGTO be fully removed or at least fully redesigned in consultation with industry.

One way to achieve the integrity-preserving goal of the exclusion while limiting its indiscriminate impact would be to retain an amended exclusion that would allow for reasonable remuneration for owners and directors who are also salaried game developers, based on the market value of the role they undertake. For example, we note that for the PDV and Location Offsets, related party transactions are simply subject to an arm's length test rather than an absolute exclusion. For those particular offsets, where a transaction is not conducted at arm's length, the expenditure able to be claimed as qualifying expenditure will only be the amount that would have been incurred if the parties were dealing at arm's length. We see no reason why such an approach could and should not be similarly adopted here for games.

To strengthen integrity even further beyond the Government's approach with the other offsets, and beyond the approaches undertaken internationally, the remuneration able to be claimed under the DGTO could even be capped at an amount set out in guidance written by the Minister (or their delegate) following consultation with industry to determine reasonable

market rates. Alternatively, or even additionally, there could be a further integrity measure implemented that the owner/director's salary must be no greater than the salary of the studio's highest paid non-owner/director employee.

Employee share schemes

Finally, while it is our understanding that a business's expenditure on salary for workers who may have a small shareholding or other equity in the business, such as through an employee share scheme or where employees have participated in crowdsourcing, will generally be able to be claimed as QADE, clarity on this through the ES would be helpful given this investment method's popularity, importance in the start-up environment, and its relative lack of riskiness from an integrity perspective.

2. Remove the requirement for a game to be released

> **378-20 Minister must issue certificates for the digital games tax offset**
>
> (2) A *digital game is completed on the earlier of:
>
> (a) when the game is first released to the general public (other than for testing purposes); or
>
> (b) if the game is developed by a company under a contract entered into at *arm's length with another entity—when the company first provides a version of the game to the entity in a state where it could reasonably be regarded as ready to be released to the general public.

The definition of a 'completed' game at 378-20(2) should be changed to also include the outcome where a business considers that the development of a game should be discontinued.

Adverse impacts of the 'completion' rule

Currently there is a requirement that a completion certificate may not be given for a digital game until the game has been released to the general public. In practice, this means that a business must finish and publicly release a game before it can apply for the DGTO. While at face value this seems like a sensible rule, its inclusion will actually be counterproductive to the DGTO, inefficient for taxpayers and even hinder the productivity of the games industry.

Game development is a highly efficient industry. A studio at all stages of a game development process will continually assess the game's likelihood of financial success and whether its continued development is warranted from a cost/benefit analysis perspective. A studio may discontinue a game for many reasons, including changes in audience preference trends, new developments in the market (such as the emergence of a competing game overseas with a larger budget), loss of key creative personnel or simply because the project is assessed as not meeting expectations.

A decision to abandon a game is never taken lightly by any studio, but whenever it is, the most productive path forward is for the studio to be able to draw a line under the work undertaken to date and to expediently move onto the next project. While superficially it may appear counterintuitive, enabling the DGTO to be claimed on a cancelled project actually contributes to maximising investment, job-creation and risk-taking, while channelling the DGTO towards higher-potential projects. This is because making the DGTO reliant upon a game being released creates a perverse incentive for a business to complete projects that are expected to

fail. Not only does this lead to the business wasting its own time and resources at the opportunity cost of commencing alternative higher-potential projects sooner, but it also ultimately leads to an inefficient allocation of taxpayer resources.

Supporting the Government's key objectives for the DGTO

It is clear that in announcing the DGTO as a key pillar of the Government's Digital Economy Strategy, one of the main priorities of the tax offset - if not the overriding one - is to create jobs and to increase Australia's share of the rapidly-growing global game development industry.

With this focus in mind, we strongly argue that whether or not a game is actually 'completed' is a less important policy driver for the DGTO than the number of new jobs that it will create. Removing the release requirement will generally make the DGTO a more attractive tool for generating investment and job creation and it is for this reason that arguably the two most modern video game tax incentives in the world, the UK's Video Game Tax Relief (VGTR) and Quebec's Multimedia Tax Credit, both allow expenditure on cancelled projects to be claimed.

As previously mentioned, there are many reasons for a game development project to be discontinued. When making decisions to invest in jobs and projects in Australia, the ambiguity of whether the tax offset will ultimately be paid on those expenses creates a significant barrier to investment, particularly when there are other jurisdictions like the UK and Quebec that do not have such a restriction. If there is any ambiguity, financially-responsible businesses are unlikely to assume that the benefit will be paid, which will ultimately impact budgeting decisions (eg. staff hires) and whether to invest in new Australian game development.

Removing the completion rule

As a result, game studios' appetite to reinvest the DGTO into more Australian jobs throughout the new game development process would be significantly undermined if there is a requirement for a game to be released before the offset is provided. If the Government desires a tax offset that will create new jobs, compete effectively with other jurisdictions, encourage the development of new high-value IP, and actually compliments the realities of the new game development process, the requirement for a game to be released should be removed.

While in some cases work on an initial game that later shifts direction could fall within the scope of qualifying expenditure on 'prototyping', it is unlikely to be applicable for many or most cancelled projects and there are likely to be difficulties faced by both industry and the Government in clarifying and resolving ambiguities around the kinds of expenditure that are claimable. Allowing a business to consider a discontinued project as 'complete' will address this problem. It will similarly also remove the need to scrutinise and resolve the question of when a game is to be considered 'complete', a process that will likely be more difficult to administer in practice than in theory.

Finally, we do not consider that following this approach will lead to abuse because no game business has any incentive to start developing a game that it does not intend to complete, even with the DGTO available. Rules could also be included to allow a certificate to be revoked in certain circumstances where the DGTO is improperly claimed, such as if a game is cancelled but is then later turned into a non-qualifying game (a scenario that we believe will be extremely rare and most likely a hypothetical risk only).

3. Enable businesses to apply for and receive provisional certificates

Businesses should be able to apply for and receive provisional certificates prior to applying for final certificates.

While it is not explicitly set out in the Draft Legislation or Draft ES, we understand that the Government proposes to enable businesses to be able to lodge provisional certificates, similar to how film and TV producers may lodge provisional certificates for the other screen offsets.

We strongly support provisional certificates as they can help some businesses to obtain greater confidence in relation to the expenses that they are able to claim. Not only will this help the businesses to budget their games more accurately and give greater surety to their investors, but it will also lead to more timely and higher quality DGTO claims for the Office for the Arts to assess.

Provision certificates are particularly vital to the attractiveness of Australia as a destination for investment from the global games industry, which prioritises certainty, forward-planning and risk management. Decisions on whether to invest in building a new studio in Australia or in another country will largely depend on how 'safe' Australia will be as a destination for that investment (which can amount to hundreds of millions of dollars or more) compared to other jurisdictions. The availability of provisional certificates will be key to this decision-making. In this regard, it is our understanding that most (if not all) project-based game development incentives overseas also offer provisional certificates or equivalent mechanisms.

However, provisional certificates should be optional for businesses as, after processes for the DGTO have been bedded down in subsequent years, they may not be necessary for some.

4. Reduce the minimum QADE requirement for porting certificates

> **378-20 Minister must issue certificates for the digital games tax offset**
>
> (3) The *Arts Minister must issue a certificate (a *porting certificate*) to a company for an income year in relation to a *digital game if:
>
> (c) the total of the company's *qualifying Australian development expenditure incurred in porting the game is at least $500,000;

The $500,000 minimum QADE requirement for a porting certificate is too high to be of practical use and should be reduced.

We appreciate the Government's thoughtfulness in providing for a specific porting certificate for businesses that may not be in a position to claim expenditure on a porting project as ongoing development (due to the $500,000 annual QADE requirement for ongoing development certificates). This demonstrates the Government's recognition of the importance of porting to the success of a game, with porting a key mechanism for attracting player and revenue growth. By enabling a game to be released incrementally across platforms, porting also helps a studio to manage risk and allocate internal resources more efficiently and sustainably.

Unfortunately, we predict that under the current Draft Legislation, porting certificates will not only be underutilised, but they will be very rarely claimed, if they are ever claimed at all, as the minimum QADE of $500,000 for a porting certificate will be too high for the vast majority of

businesses. Our members have told us that their porting costs rarely, if ever, come close to $500,000, with one of our members telling us that the porting of their most recent title across multiple platforms only required a $200,000 total budget.

While we appreciate the simplicity, as porting projects generally cost far less and take less time to complete than finishing the base game, it arguably is not logical for both completion and porting certificates to have the same minimum QADE requirement. Given that the porting of a game often demands an indie studio's full capacity following the release of the game, many studios will also never reach the $500,000 minimum QADE requirement to apply for an ongoing development certificate either. Further, if the minimum QADE requirement for a porting certificate is kept high, it also creates a risk that the cost of porting by sub-contractors will become artificially inflated, causing harm to not only game development studios but also to the integrity of the DGTO.

We recommend that the minimum QADE requirement for a porting certificate be reduced as much as possible. While our recommendation would be that the threshold be no higher than $250,000, we are conscious that even at this level the minimum spend required is still greater than many porting projects will be able to reach. If a reduction of the threshold is not possible, one practical solution to help resolve this issue, while generally retaining a nominal $500,000 QADE threshold, is to reduce or waive the QADE requirement for porting certificates where the game has already obtained a completion certificate. This will guarantee that the project for which a porting certificate has been sought has already satisfied a $500,000 QADE requirement.

5. Clarify that businesses that work on a part of a larger project are eligible

378-20 Minister must issue certificates for the digital games tax offset

(8) The conditions in this subsection are that the company that applies for a certificate in respect of a *digital game:

(a) either:

(i) develops the game as an original game; or

(ii) if the game is a *completed game—owns or controls the rights to develop the game, or has been engaged to develop the game by the entity who owns or controls the rights to develop the game; and

(b) is primarily responsible for undertaking activities necessary for the development of the digital game.

Draft ES

1.24 A company is eligible for a certificate in relation to an eligible game where the company is primarily responsible for the actual development of the game. This would be a company that owns or controls the rights to develop the digital game and that itself undertakes the development of the game. This is regardless of whether the game is a new game or an existing game.

1.25 A company that has been engaged to develop the game by the entity who owns or controls the rights to develop the game is also eligible for a certificate in relation to the game if, it is primarily responsible for undertaking activities that are necessary for the development of the digital game in Australia. A company that makes an unauthorised modification of a game is not an eligible company.

The Draft Legislation or Draft ES should be clarified to ensure that businesses can apply for a certificate for expenditure on the development of games for which they have only been responsible for developing a discrete component.

We have been advised by the Government that the DGTO is designed to allow a business to make a claim where the business has only been responsible for completing a portion of the game rather than the game in its entirety.

This is a common arrangement for major 'AAA' games that involve several studios working together. For example, the Australian subsidiary studio of a major global games company may work alongside its sibling studios in other countries to jointly deliver a game. Alternatively, an independent Australian studio may be engaged via a work-for-hire model to deliver one component of a larger game that will still primarily be developed overseas by a third party. This arrangement is often used where the independent Australian studio has a valuable specialisation (eg. art design) or is simply not yet large or experienced enough to deliver the full project (although such projects will be vital in helping the studio to grow).

While we are confident the Government considers that such projects should be covered by the DGTO (assuming all other relevant requirements are met), we believe that the drafting of the legislation and the ES does not make this immediately obvious. For example, the legislation at 378-20(8)(b) includes the language "is primarily responsible for undertaking activities necessary for the development of the digital game", which could be construed as meaning that only the 'chief developer of a game' (ie. the company that engages an Australian studio) may theoretically claim the DGTO. Further, Paragraph 1.25 of the Draft ES uses slightly different wording of: "is primarily responsible for undertaking activities that are necessary for the development of the digital game in Australia". This is better language as it arguably covers explicitly the chief developer of a game *in Australia*, but the intent of the paragraph is still not as clear as it potentially could be.

6. Remove the phrase "transferred or" from the description of loot boxes

Draft ES

1.33 However, the policy for excluding a digital game that substantially comprises gambling or gambling-like practices is intended to also exclude digital games that substantially comprise, have reliance on, or give prominence to, certain types of 'loot boxes'. The Arts Minister will issue guidance to assist taxpayers to understand how the definition of 'substantially comprises gambling elements' including in relation to loot boxes will be applied in practice.

1.34 Loot boxes are not defined in the Act, but loot boxes likely to make a game ineligible are understood to expressly allow a player the ability to directly or indirectly purchase with real currency unknown virtual items determined by randomisation or chance and allow, within the game, for those items to be transferred or cashed out for real currency.

The phrase "transferred or" should be removed from the description of loot boxes at paragraph 1.34 of the ES.

The language in the Draft ES concerning loot boxes should be clarified and amended to avoid unintended impacts on unrelated game mechanics.

We appreciate that the intent of the Draft Legislation is to exclude from eligibility games that are gambling services or substantially comprise gambling or gambling-like practices.

However, we believe the language in paragraph 1.34 of the Draft ES inaccurately conflates gambling with a vast array of loot boxes that are not and should not be considered gambling or gambling-like. Paragraph 1.33 refers only to 'certain types' of loot boxes. However, paragraph 1.34 then adds confusion to the limited scope of paragraph 1.33 by including not only loot boxes that allow players to obtain items that may be 'cashed out' for real currency, but potentially also items that may be 'transferred' within a game.

The transfer and exchange of virtual items within games is commonplace across the industry, including items initially obtained from loot boxes. As long as such items are restricted to in-game transfers, and there is no mechanism to cash out such items for real currency within the game, there is no risk of gambling-like practices. Put simply, the 'certain types' of loot boxes referenced in paragraph 1.33 are only loot boxes that enable players to cash out the acquired items for real money within the game and the ES should clearly reflect that limited scope of concern. In order to preserve the intent of paragraph 1.33, we recommend that the phrase "transferred or" be removed from paragraph 1.34.

Finally, we note that the Arts Minister will issue practical guidance regarding the definition of "substantially comprises gambling elements". We ask that consultation with industry be conducted prior to the finalisation of any such guidance.

7. Clarify or revise the rule regarding 'related companies' and the $20 million cap

378-15 Amount of digital games tax offset

(2) Despite subsection (1), if 30% of the total amount of *qualifying Australian development expenditure for the income year, as determined by the *Arts Minister under section 378-25, of:

(a) the company; and

(b) each other company (each of which is a *related company*) that is *connected with or is an *affiliate of the company;

exceeds $20,000,000, then the amount of the digital games tax offset for the company for the income year is the amount worked out under subsection (3) or (5) of this section (as applicable).

Draft ES

1.15. This cap applies to the offset for a single company. But the cap also applies to any amount of cumulative offset to which a group of related companies would be entitled to. A related company is a company that is connected with or is an affiliate of a company.

1.16. The definitions of a company's affiliate and where a company is connected to another company are provided in sections 328-130 and 328-125 of the ITAA 1997 respectively. Generally, an affiliate of a company is a company which acts, or could reasonably be expected to act, in accordance with the first company's direction or wishes.

1.17. Applying the cap across a company and its related companies is an integrity measure aimed at addressing corporate structuring specifically design to defeat the $20 million offset cap.

Clause 378-15(11) and paragraph 1.101 of the Draft ES regarding consolidated or MEC groups as well as the 'single entity rule' are also relevant to this issue.

The Draft Legislation and Draft ES should be clarified, or if needed revised, to ensure that companies are not related merely because they are fully or partially owned by the same company (or by companies owned by the same company). For example, the ES could outline some indicative examples of arrangements demonstrating when companies are

likely or unlikely to be related. If the related company rule is intended to apply strictly, we strongly ask that it be softened so as not to discourage investment.

The definition of 'related company' in the Draft Legislation is based on definitions of a company's affiliate and a connected company, which are themselves defined - not entirely with clarity - elsewhere in the ITAA 1997. As a result, this part of the Draft Legislation is one of the most difficult to navigate while also being one of the most critical. The related definition in the Draft Legislation of a member of a consolidated group or a 'MEC group' is also unclear, as is the extent of the practical impact of the 'single entity rule' on the application of the DGTO.

Impact of the rule on long-term investment

Video games are an extremely high investment sector, easily the highest of any creative sector, with mergers and acquisitions of games companies worth tens of billions of dollars globally each year. Many high investment games companies will own or partially own dozens of studios all around the world, sometimes called their 'stable', and often with several within a territory. This has been the experience of countries like Canada and the UK and one of the key reasons why their game development industries are multiple times the scale of ours.

The main way that the Australian games industry will experience explosive growth following the implementation of the DGTO is through foreign investment, including foreign acquisition and capital injections into existing Australian studios and the establishment of brand new studios in Australia that will likely represent billions of dollars in activity. This will necessarily involve some global companies eventually owning, or having equity interests in, more than one studio in Australia.

While we urge that the DGTO be uncapped, we do agree that if it is capped, companies should not use "corporate structuring specifically designed to defeat the $20 million offset cap" (paragraph 1.17 of the Draft ES). On the other hand, we believe it to be vital that companies that share a parent company or have common investors, but otherwise have no operational or business relationship, should not be forced to share a single $20 million DGTO cap. Otherwise, global games investors will be disincentivised from owning more than one Australian studio, potentially resulting in a loss of billions of dollars of investment to the local economy.

Achieving a practical balance

It is our understanding from our conversations with the Government that the 'related company' rule is meant to be a targeted tool for integrity protection and is not necessarily intended to have a broader impact on growth and investment. However, there is significant uncertainty from a plain reading of the Draft Legislation and Draft ES and greater clarity will go a long way to provide certainty to global investors.

For example, assuming no change to the Draft Legislation is needed, the ES could clarify that companies will not generally be related to each other, notwithstanding any shared investors or parent companies, as long as:

- neither companies act or could reasonably be expected to act in accordance with the other company's directions or wishes (to borrow the language of 1.16 of the Draft ES)
- the companies do not work on any common projects or common IP, and

- both companies retain a significant amount of operational independence from any common investors or parent company (businesses would need to demonstrate this, such as by proving that any relevant Board members have limited oversight roles only).

8. Revisit the $20 million annual limit for businesses claiming the DGTO

> **378-15 Amount of digital games tax offset**
>
> (1) The amount of the digital games tax offset for a company for an income year is:
>
> (a) unless paragraph (b) applies—30% of the total of the company's *qualifying Australian development expenditure for the income year, as determined by the *Arts Minister under section 378-25; or
>
> (b) if the amount worked out under paragraph (a) exceeds $20,000,000—$20,000,000.

To fully realise the tax offset's potential for generating investment, economic activity and job creation, the $20 million annual 'cap' on the DGTO should be removed or increased.

While we appreciate that the Government has been fully transparent since its first announcement of the DGTO in 2021 that the offset will be subject to a $20 million maximum annual claim per business, we nevertheless note that neither the Producer, Location nor the PDV Offset available to the film and TV sector are capped and there is no clear policy rationale as to why a tax offset for game development should be differently designed in this regard. Further, as the Government is aware, video game development tax offsets, credits and rebates that have been implemented overseas generally are not capped.

It is clear that in announcing the DGTO as part of the Digital Economy Strategy, one of the key priorities of the tax offset - if not the overriding one - is digital job creation and investment. Unfortunately, while few existing studios in Australia will be immediately limited by the $20 million cap, the cap will dampen the DGTO's long-term ability to achieve the maximum economic growth that the Government most strongly desires for our high potential digital sector.

In practice, the $20 million cap simply makes Australia a less competitive jurisdiction for global investment compared to the jurisdictions that we are most directly competing with. In this global environment, it will also place an upper limit on the maximum size of an Australian studio as well as the number of studios that a global company will plant in Australia. For example, some games companies individually employ thousands of workers in countries like Canada, aided by tax incentives that are otherwise similar to the DGTO but are uncapped. The $20 million cap will mean that we are unlikely to experience the same outcome here.

Further, another benefit of dismantling the $20 million cap is that it will entirely remove the need for the 'related companies' rule discussed above, avoiding the need for the Government to administer what we expect to be one of the most challenging areas for the implementation of the DGTO.

While ideally the DGTO is uncapped, if a 'cap' is nevertheless retained, it should be increased to a higher limit – such as $40 million. If even this is not feasible, we ask that as a minimum the DGTO's proposed $20 million cap be indexed to CPI as inflation will otherwise significantly erode the value of the DGTO over the long term.

Other recommendations

9. Add additional categories of game developers to the specific inclusions

> **378-30 Development expenditure**
>
> (2) Without limiting subsection (1), the following expenditure of a company in relation to a *digital game is (subject to subsection (3)) *development expenditure*:
>
> (a) remuneration provided to employees and independent contractors engaged by the company who carry out work in connection with the development of the game, including the following:
>
> (i) software developers, programmers and engineers;
>
> (vii) project managers;

Remuneration for 'engineers', 'producers', 'product managers' and 'community managers' should be added to the list of specific inclusions of employee remuneration considered to be QADE at 378-30(2)(a).

While expenditure on engineers and producers, and potentially product managers, is already most likely considered QADE for the DGTO, we believe these roles should be specifically listed in the legislation given their importance and ubiquity to the game development process.

Engineers, producers and product managers

While software engineers, alongside software developers and software programmers, are already a specified inclusion at 378-30(2)(a)(i), video game development often depends on a much broader range of engineering roles beyond strictly software, including graphics, physics and audio engineers. For clarity, the inclusion of engineers should not be restricted to software engineers as it currently appears to be.

Producers are one of the most senior and important roles in the creation of a game and generally have a much more direct and hands-on role when compared to film and TV 'producers'. Also, unlike film and TV producers, games producers are typically salaried and do not ordinarily have an equity stake. We suggest that producers be added to 378-30(2)(a)(vii) alongside project managers (these two roles are often interchangeable). The ES could also differentiate between video game producers and film/TV producers, should there be concerns with the fact that remuneration for the latter is generally not able to be claimed for the other screen offsets.

For 378-30(2)(a)(vii), we also suggest the inclusion of the role of product manager, which is a key game development role that is most prominent in the ongoing development phase of a game. Product managers will often be a key or lead decision-maker for how a game can be strengthened, improved or expanded. The inclusion of this role is essential.

Community managers

While not specifically listed at 378-30(2)(a) and therefore potentially not considered QADE, we strongly recommend the explicit addition of community managers. Community managers are essential to the game development process and are typically a member of a game development team (rather than marketing). Our members and advisors have told us that community managers are particularly vital to the testing and ongoing development phase of a game project. Among other responsibilities, they serve as a lynchpin between a studio's technical and creative development teams and the gaming community. Key decisions about

how a game is developed or strengthened are often informed by data collected and channelled through skilled community managers.

10. Include expenditure on game-related technology and architecture development

Add a specific inclusion at 378-30(2) to enable expenditure on the development of technology and architecture, where it is related to the development of the game, to be claimed, including the development of a game engine.

It would be highly constructive for the DGTO to specifically include as eligible expenditure work on appropriate forms of underlying technical infrastructure related to a game, such as the development of a game engine upon which a game is built. For example, many game studios of various sizes may first choose to build their own bespoke game engine before commencing the development of a game.

While perhaps less commonly front-of-mind compared to other more visible forms of game development work such as creating characters or levels, the development of underlying infrastructure like game engines is just as vital and often leads to great innovation in game design, not only for the game it has been primarily developed for but for subsequent titles that can also benefit from the investment.

While we believe that in many cases such expenditure would likely already be considered QADE, such as through the specific existing inclusions for engineers, research and prototyping, we believe it would be useful to provide for a specific inclusion for this category of key development work. In addition to game engines, other forms of technology, architecture or infrastructure that could be built by a games studio for its titles include accessibility functionality, online safety controls, anti-cheating and anti-piracy controls, monetisation tools, 'plug-in' and customisation capabilities and blockchain.

We do not expect there to be any major integrity risks with this proposed inclusion. We note that to claim this kind of expenditure as QADE, a business would still need to demonstrate that the expenditure was incurred in or in relation to the development of the game. In other words, the work undertaken would still need to be linked to a specific game and until a game has been developed using the technology, or until the technology is applied to a specific game, its expenditure is not claimable.

To avoid doubt, only labour-related expenditure associated with the development of the technology would be claimable. Further, where the expenditure is potentially linked to more than one game (eg. where two games are built on the new game engine or share a custom anti-cheating control) the expenditure could obviously only be claimed once.

11. Clarify the rule against expenditure on 'further sub-contracting'

378-30 Development expenditure

(3) Despite subsections (1) and (2), the following expenditure of a company in relation to a *digital game is not ***development expenditure***:

(a) expenditure on subcontracting by the entity engaged to develop the game;

Draft ES

1.62 Expenditure on further subcontracting for the development of the game is excluded as an integrity measure. Expenditure incurred by the primary development company engaging an independent contractor is eligible expenditure; however, under this provision, if that independent contractor further sub-contracts then the expenditure on the independent contractor is no longer eligible expenditure. Without this provision, an entity could engage in complex structuring arrangements that would be able to circumvent other integrity rules, including those relating to excluding expenditure to related parties. This provision helps ensure that the offset remains targeted at companies that are directly responsible for the development of the game, whilst retaining sufficient flexibility for those companies to source specialist or creative goods and services, but avoids creating integrity risks.

The rule against claiming expenditure on 'further sub-contracting' should be clarified to ensure that it relates only to the expenditure on sub-contracting incurred by a business that is already a sub-contractor to the business claiming the DGTO.

How the rule relates to individual independent contractors should also be clarified.

Complexity and definitional issues

While it is clear that there is no general exclusion of sub-contracting expenditure, but rather an exclusion of sub-contracting expenditure incurred by a business that is already a sub-contractor to a DGTO claimant (we understand the Government's rationale for this exclusion), the feedback we have received from members is that the existing draft wording could cause confusion. This could be rectified by a statement in the ES to the effect that subcontracting is generally permitted, but with an example provided of the specific kind of 'circular' expenditure that the Government is trying to prevent from being claimed.

In particular, we raise a potential phrasing issue with the exclusion of sub-contracting expenditure by an "entity engaged to develop the game" at 378-30(3)(a). While this line is clearly designed to exclude 'further sub-contracting', we note that some businesses that will be claiming the DGTO will technically be an "entity engaged to develop the game" - but not in the sense that the drafters of the legislation are intending. For example, an Australian studio engaged to develop a game for an international client under a work-for-hire model might meet this description under the current wording but is still the primary entity for the purposes of claiming the DGTO. It is important that such businesses remain able to claim the DGTO on expenditure for sub-contractors that they engage.

Independent contractors

While we understand that the purpose for the rule against 'further sub-contracting' is to prevent the risk of 'circular' rorting between businesses, we also warn against any exclusion of expenditure on sub-contractors that relate to the employment of independent contractors. Many games companies, including work-for-hire or other specialist service providers, may hire a mixture of fulltime employees and individual independent contractors (ie. workers employed on a contractual basis). Often this may be due to the preferences of independent contractors

who prefer flexibility. As they are analogous to regular employees, expenditure on independent contractors by a sub-contractor should not be rendered ineligible for the purposes of the DGTO.

Similarly, we also believe that the wording in 378-30(2)(a) allowing expenditure on "remuneration provided to employees and independent contractors engaged by the company who carry out work in connection with the development of the game" may cause confusion to businesses that are unclear if the reference to 'independent contractors' is intended to limit claims to individual game developers hired on a contract basis and therefore by omission excludes that same expenditure where they are engaged through sub-contracted or labour hire companies. We know this is not the intent, but again it is an area where clarity would be welcomed.

12. Soften the penalty where related companies' claims exceed $20 million

378-15 Amount of digital games tax offset

(5) If subsection (3) does not apply, the amount of the company's digital games tax offset for the income year is nil.

When the sum of claims by 'related companies' exceeds $20 million, the amount of the DGTO for the income year should be $20 million, not 'nil'. Alternatively, the Government could be given a clawback power to ensure any excess money paid is reclaimed.

Under the Draft Legislation, the amount of the DGTO for the income year in such cases will be nil. Even if in practice the Government exercises this most extreme outcome with great discretion, we believe that this is an unnecessarily and unreasonably punitive potential punishment that may not always lead to a just outcome where 'related companies' have made an innocent mistake when lodging their DGTO claims.

13. Clarify in the ES that 'ongoing development' also means maintaining a game

Draft ES

1.49 A company can apply for an ongoing development certificate for an income year in relation to the ongoing development of one or more digital games. Ongoing development means activities undertaken to update, expand or improve a digital game that has already been completed. This development activity can include the addition of new levels, maps, characters, vehicles, storylines, cosmetic items, addressing 'bugs' or porting to new platforms. The ongoing development certificate can be claimed with respect to expenditure on multiple eligible games incurred in the income year to which the certificate relates.

The explanation of 'ongoing development' at paragraph 1.49 of the Draft ES should be updated to include the word 'maintain', mirroring the wording in the Draft Legislation.

Paragraph 1.49 of the Draft ES currently states that ongoing development means "activities undertaken to update, expand or improve a digital game that has already been completed". Unlike the actual definition of 'ongoing development' in the Draft Legislation at 378-20(6), the word 'maintain' has been omitted. The inclusion of the word 'maintain' is important because games often require a range of ongoing development work to ensure that it remains robust,

reliable and efficient. This work may not always necessarily introduce 'brand new' playable content, but it is just as vital for ensuring that the game continues to remain high quality and to retain existing players and attract new ones.

14. Timing of game release to mean the official launch

378-20 Minister must issue certificates for the digital games tax offset

(2) A *digital game is completed on the earlier of:

(a) when the game is first released to the general public (other than for testing purposes); or

(b) if the game is developed by a company under a contract entered into at *arm's length with another entity—when the company first provides a version of the game to the entity in a state where it could reasonably be regarded as ready to be released to the general public.

378-20(4) also includes a reference to "first released to the general public".

Guidance should be provided in the ES that the meaning of "first released to the general public (other than for testing purposes)", in the context of when a game is completed, generally means when a game is officially launched to the general public.

The wording in the Draft Legislation is generally appropriate, but the ES could provide some further guidance to allow both businesses and the Government to avoid misunderstandings around when a game is considered completed. Most games will have a date upon which they are officially 'released' or 'shipped'- typically first on a digital game distribution platform - and it will be easiest and most appropriate to determine that the game has been completed at that point.

While there have been examples of games being released 'in beta' to the public for such an extended period of time that there may be real questions around whether it should be considered complete, they are very rare and we believe the Draft Legislation is already flexible enough to deal with them. As a further failsafe, we note that the Draft Legislation at 378-35(3)(c) already states that expenditure on game development incurred after one year of public testing cannot be claimed under the completion certificate stream of the DGTO.

15. Consistent language regarding the 'general public'

378-35 Qualifying Australian development expenditure

(3) For the purposes of a *digital game in respect of which a completion certificate is applied for, the expenditure is not *qualifying Australian development expenditure* to the extent it is incurred after the earlier of the following:

(a) the day on which the game is *completed;

(b) the day on which the company applies for a completion certificate in relation to the game;

(c) the day on which the game has been available to the public for the purposes of conducting testing for one year.

The word 'public' at 378-35(3)(c) should be changed to 'general public' for consistency.

The phrase 'general public' is used in all other relevant parts of the Draft Legislation except here, where 'public' is used. While mostly similar, 'public' and 'general public' may potentially have different meanings in the context of game testing because an alpha or closed beta testing process (eg. where certain members of the playing community are eligible to join via invitation or lottery) in some circumstances could possibly be considered technically open to the 'public' but is less likely to be considered open to the 'general public'.

16. Confirm that employee remuneration can be split across multiple claims

Draft ES

1.91 If an item of expenditure is directly but may be in part - but not substantially - attributable to developing the game, the item is claimable to the extent that the expenditure is attributable to developing the game. For instance, where an employee is developing both an eligible game and an ineligible game, only the expenditure in relation to the eligible game is claimable.

It would be helpful for the ES at paragraph 1.91 to also explicitly state that where an employee is developing two or more eligible games, the relevant expenditure incurred in relation to each eligible game is separately claimable.

Across many game development studios in Australia, employees may simultaneously or sequentially work on multiple games. While it is implied that the Draft Legislation intends that expenditure on such employees may be split across any eligible games that they worked on for the purposes of claiming the DGTO, this is not explicitly made clear in either the Draft Legislation or the Draft ES. It also goes without saying that there should be no double-counting of the same expenditure, which could also be spelled out in the ES if considered necessary.

Additional matters

$500,000 minimum QADE requirement for completion certificates

We understand that all screen tax offsets must necessarily have a minimum expenditure requirement. We also recognise the Government's policy rationale for a qualifying threshold that strikes a balance between being low enough to be accessible to a reasonable proportion of small-to-medium-sized businesses (SMEs) on one hand, but also sufficiently high so as to focus on higher-investment and more market-ready projects. We further appreciate that a $500,000 minimum QADE requirement for a completion certificate is commensurate with the film and TV offsets, and as it is a whole-of-budget rather than an annual requirement, a larger proportion of SMEs will be able to access the DGTO and benefit from the support it provides.

Nevertheless, some of our members have raised concerns with us that in the game development context, a $500,000 minimum QADE requirement will still be exclusionary for smaller companies that will be unable to access the DGTO to achieve the growth and investment that the sector needs. In particular, they have warned that smaller studios would be particularly disadvantaged against larger studios that can access the DGTO and thereby hold a competitive advantage in attracting investment, funding projects, hiring staff and executing publishing deals. This could result in a negative feedback loop where small studios continue to be left behind while larger studios accelerate their growth. Our members further highlighted the significant risk in omitting smaller studios from support as they are often where each new generation of game developers first begin their careers and are therefore vital to the talent pipeline. In addition to our members, similar concerns with the $500,000 threshold have also been raised with us by the Australian Government's Office of the Small Business & Family Enterprise Ombudsman, a fierce supporter for our sector and a major advocate of the DGTO.

We appreciate the fact that the DGTO will be part of a larger and more holistic games funding ecosystem alongside Screen Australia's Games: Expansion Pack fund that complements the DGTO by being limited to games with a budget of less than $500,000. However, we also note that this funding is discretionary, is relatively modest in overall scale (especially compared to Screen Australia's film and TV funding) and, most importantly, currently only has funding committed until 2022-3. Should the minimum QADE requirement remain at $500,000, it is essential that sufficient funding be committed to Screen Australia so that it can continue to provide adequate long-term support to our sector.

Eligibility of non-labour expenditure

We note that the Government has made a policy decision to exclude from QADE several categories of common video game expenditure, including, among other things, general overheads and expenditure on hardware, software and the acquisition of copyright. As the Government is aware, we advocated for the inclusion to QADE of these (and other) categories of expenditure during the early development of the Draft Legislation.

We further note that this strict approach differs significantly from the film and TV offsets, where a much broader range of expenditure can be claimed. For example, the cost of 'hiring items', asset depreciation and expenditure on Australian copyright can be claimed under the Producer Offset, while eligible expenditure for the PDV Offset includes 'goods', travel and some insurances, legal and accounting costs. The Location Offset further accommodates general business overheads, some publicity and promotional costs and, explicitly, non-salary remuneration and residuals. While screen tax offsets are always challenging to neatly compare

as they have different objectives and key features, there is an undeniable reality that the DGTO has by far the most restrictive approach to eligible expenditure of all the screen offsets, with a lack of clear practical reasoning as to why this is necessary or appropriate.

In this regard, some of our members have told us that the exclusion of most non-labour expenditure from the DGTO in comparison with the film and TV offsets will be disadvantageous for many studios, particularly smaller studios where, in comparison with larger studios, the ratio of non-labour to labour expenditure in a project budget will be much higher. They have further questioned why at least some of the non-labour expenditure permitted for the film and TV offsets cannot also be claimable under DGTO as long as it is Australian expenditure, even if only a proportion of total expenditure can be claimed. Expenditure on hardware and software were especially highlighted as vital investments.

Given our prior advocacy, we recognise that the Government has considered and made an informed decision, presumably for budgetary and other policy rationale, to exclude most non-labour studio expenditure. We have also ultimately chosen not to include a specific recommendation on this topic in our submission on the basis that, from a whole-of-industry view, there are other recommendations for Government consideration that are of more immediate priority. Nevertheless, we have included our concerns on this topic to ensure that our submission represents our members as comprehensively as possible and to flag that this will be matter that we will continue advocating on following the implementation of the DGTO.

Any questions?

For more information on any issues raised in this submission, please contact IGEA's Director of Policy & Government Affairs, Ben Au, at ben@igea.net

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